

Decision 01-09-057 September 20, 2001

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Citizens Utilities Company of California (U-87-W), a California Corporation, and California-American Water Company, a California Corporation, for Each of the Following Orders:

1. Authorizing Citizens Utilities Company of California to Sell and to Transfer All of Its Water Utility Assets and Indebtedness to California-American Water Company;
2. Authorizing California-American Water Company to Acquire All of the Water Utility Assets and Indebtedness of Citizens Utilities Company of California and thereafter to Engage in and Carry on the Water Utility Business and Service to the Customers of Citizens Utilities Company of California;
3. Authorizing Citizens Utilities Company of California to Withdraw from the Water Utility Business; and
4. For Related Relief.

Application 00-05-015
(Filed May 16, 2000)

And Related Matter.

Application 00-05-016

(See Appendix A for Appearances)

OPINION AUTHORIZING ACQUISITION

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APPENDIX A – List of Appearances

Summary

Under Application (A.) 00-05-015, Citizens Utilities Company of California (Citizens) is authorized to sell and transfer, and California-American Water Company (CalAm) is authorized to acquire, all of Citizens' California water utility assets and its California Safe Drinking Water Bond Act Loan indebtedness. The authority granted is subject to various ratemaking-related conditions proposed by the applicants in their alternative sharing proposal tendered during the final days of hearing in the proceeding. Upon completion of the transfer, CalAm shall assume all of Citizens' water public utility obligations.

Separate but related A.00-05-016 requesting authority to merge San Jose Water Company (San Jose Water, or SJW) into CalAm is dismissed without prejudice at the request of the applicants.

Background

Overview

The CalAm/Citizens Application

In A. 00-05-015 (Application), CalAm and Citizens (jointly, Applicants) seek authority for the transfer of all of Citizens' water utility assets and related assets in California to CalAm under terms and conditions set forth in an asset purchase agreement between the companies. Citizens' four water utility operating districts in California would become a CalAm division. CalAm would assume responsibility for providing regulated water utility service to former Citizens customers, and Citizens would be relieved of its water public utility obligations. The purchase price is \$161.32 million, subject to certain adjustments

upon closing.¹ CalAm would assume Citizens' Safe Drinking Water Bond Act indebtedness to the California Department of Water Resources and would pay the loan balance in cash. Because Citizens has historically done all of its debt financing through its parent company, Citizens has no other indebtedness for CalAm to assume.

To secure Commission approval, Applicants set forth a complex proposal for setting future rates that varies from the method that would otherwise be followed under California's Public Water System Investment and Consolidation Act of 1997, Public Utilities Code Sections 2718 through 2720.² That proposal, modifications made to it during the course of the proceeding, and an alternative proposal Applicants presented near the conclusion of the proceeding are described in a section to follow.

The CalAm/San Jose Water Application

At the same time the CalAm/Citizens Application was filed, CalAm, San Jose Water and various of their affiliates filed A.00-05-016 for Commission approval of a series of acquisition and merger transactions that would have resulted in merger of San Jose Water into CalAm with CalAm being the surviving entity. The applicants in A.00-05-016 proposed future ratemaking provisions largely identical to and integrated with those of the CalAm/Citizens acquisition. A.00-05-015 and A.00-05-016 were subsequently consolidated.

On March 8, 2001, following 20 days of evidentiary hearings, CalAm and San Jose Water filed separate motions to withdraw A.00-05-016 without

¹ This represents a \$64.553 million acquisition premium over book value of the regulated assets.

² Statutory references are to the Public Utilities Code unless otherwise noted.

prejudice. CalAm stated that delays in the proceeding had made it impossible for the Commission to render a favorable decision by the April 28, 2001 termination date in the CalAm/SJW merger agreement, and that it would be impractical for the parties to extend the agreement. San Jose Water gave no reason for its motion. Intervenor Advocates for the Public Interest (API) supported dismissal, but urged the Commission to state that the delays and problems encountered were of the applicants' own making.

Since no party opposes dismissal, the applicants' motions to dismiss A.00-05-016 will be granted. The remainder of this decision pertains primarily to A.00-05-015 except where noted.

The Parties and Their Positions

California-American Water Company

CalAm is the fourth largest investor-owned water utility in California. It provides domestic water service to 112,000 customers through separate systems in Coronado and a portion of the City of San Diego, six cities and certain unincorporated areas of the Monterey Peninsula in Monterey County, portions of several cities and unincorporated areas of Los Angeles County, and the City of Thousand Oaks in Ventura County. CalAm is a wholly-owned subsidiary of American Water Works Company, Inc., a Delaware corporation listed on the New York Stock Exchange. American is the largest investor-owned water utility in the United States, serving 10,000,000 people in 23 states.

CalAm's purchase of Citizens' California water assets is part of American's larger purchase of all of Citizens' parent company's water and wastewater assets in the U.S. According to CalAm, the U.S. water industry faces significant challenges over the coming decades because of the need to replace

aging infrastructure to meet more rigorous regulatory standards. The federal Safe Drinking Water Act and the federal Clean Water Act are two primary examples of those standards. These challenges are part of a driving force behind consolidation in the industry. While companies such as CalAm and American are large by U.S. water industry standards, consolidation has taken on an international scope, and U.S. companies are not large when compared to either their foreign counterparts or to domestic energy and telecommunications utilities. Foreign water companies have made inroads in the U.S. market, and for many U.S. water companies, survival depends on building enough financial bulk and operating capability to compete with them. Because the opportunities for expansion in the water industry have been constrained by relatively flat growth in demand and customers, U.S. companies, including American, are looking to acquisitions such as this one to enhance shareholder value.

CalAm believes that consolidation of these two sizable water companies would lead to greater economies of scale and rates lower than they would have been absent consolidation. In support of its position, it prepared a study of the very considerable synergies it expects to generate, and proposes to share the resulting savings with ratepayers as an inducement to obtain Commission approval of the Application. CalAm's initial sharing proposal was set forth in the Application (the "Application sharing proposal"). The Application sharing proposal later evolved considerably through changes introduced during the course of evidentiary hearings, the addition of detail not defined in the Application, and an update to reflect withdrawal of the companion CalAm/SJW merger application. In the final days of hearings,

CalAm³ tendered a final offer (the “alternative sharing proposal”) incorporating much of the same implementation detail but offering future ratepayers a considerably enhanced share (90% to ratepayers) of the synergies savings remaining in any year after CalAm earns a return of and on⁴ the acquisition premium. Its Application sharing proposal would have given just 5% to ratepayers. CalAm has crafted each of its proposals so as to ensure that future ratepayers would never experience an acquisition premium-driven rate increase that exceeds the annual synergies savings generated from the acquisition. Each proposal is further described below.

In addition to the quantifiable ratepayer benefits, CalAm sees a host of non-quantifiable and non-monetary advantages for Citizens’ ratepayers through the acquisition. Among those, it lists: enhanced ability to respond to emergencies and natural disasters; access to in-house laboratory and research capabilities in California and nationally; annual customer satisfaction surveys and incentive compensation tied to customer service; specialized in-house design and engineering capabilities; enhanced employee career growth and training opportunities; participation in an Environmental Protection Agency partnership program designed to enhance water quality; greater ability to acquire and

³ Throughout this discussion, CalAm is cited as the sponsor of the synergies analysis and post-acquisition ratemaking proposals because as the future service provider it took a more active role than Citizens in evidentiary presentations. It should be understood, however, that Citizens joined in support of all positions described here as those of CalAm.

⁴ “Return of and on” is a term of art used throughout the proceeding. “Return of” refers to CalAm’s recovering over time through future rates the amount by which its purchase price would exceed the asset book value of the plant it is acquiring. “Return on” refers to CalAm’s receiving a rate of return on the declining balance standing unrecovered at any future point in time until that full acquisition premium has been recovered in rates.

upgrade small, troubled water companies in California; and CalAm's single industry focus in contrast to Citizens' multi-industry diversification. And, perhaps most importantly, both CalAm and Citizens stress that Citizens is divesting itself of all of its other water and wastewater operations nationwide. Unless it can sell its California facilities to a larger water utility, Citizens' California water operations will lose many of their current economies of scale, it will be more difficult to attract and maintain qualified personnel, and today's rate and service levels will be put at risk.

Citizens

Citizens serves approximately 66,000 water service connections in four California districts: Larkfield in Sonoma County; Felton in Santa Cruz County; Montara in San Mateo County; and scattered locations in Sacramento and Placer Counties. The Sacramento and Placer County service areas include the City of Isleton and vicinity, the City of Citrus Heights, and a large number of smaller, unincorporated areas. Citizens Utilities Company of California is a wholly-owned subsidiary of Citizens Utilities Company, a Delaware corporation listed on the New York Stock Exchange. In 1999, Citizens' parent announced it would divest its water distribution, wastewater treatment, gas distribution and electric distribution businesses as part of a corporate strategy to position itself as a pure telecommunications service provider. Shortly after, in October, 1999, American agreed to acquire all of its water and wastewater assets, located in California and five other states. In comments on the ALJ's Proposed Decision, Citizens reports that all five other states have now issued final decisions approving the transaction.

Citizens' position closely parallels that of CalAm: This acquisition will transfer Citizens' California regulated water assets and customers into the hands of an exceptionally well-qualified operator. The purchase price was the result of arms-length negotiation and represents fair market value. Ratepayers will reap very substantial quantifiable and non-quantifiable benefits that would not be available otherwise.

Advocates for the Public Interest

Advocates for the Public Interest is an unincorporated nonprofit association found eligible for intervenor compensation as a customer of the third type, *i.e.*, a group or organization authorized by its bylaws or articles of incorporation to represent the interests of residential customers.⁵ API intervened early in both applications and took an initially critical view of the value to ratepayers of the Citizens acquisition (and the now-defunct San Jose Water merger) and of CalAm's synergies savings assumptions. CalAm's proposal to pay a large premium over book value and then attempt to recover that premium from savings it hoped to generate represented, in API's view, a significant risk to ratepayers. Among the three stakeholders, Citizens would benefit immediately and depart the transaction with a large reward and little or no risk; CalAm would have first claim to apply any synergies savings against its purchase premium and would receive 95% of any remaining synergies; and ratepayers would be in line for the remaining 5%. Should the acquisition not produce the projected level of synergies, ratepayers would receive no

⁵ API filed Notices of Intent to Claim Intervenor Compensation in each application on July 24, 2000, and was found eligible by the Administrative Law Judge's (ALJ) ruling of September 6, 2000.

quantifiable benefits and could actually be harmed if CalAm's financial position and ability to provide adequate service were weakened. API urged the Commission to strike a better balance between ratepayers' risks and rewards and those of CalAm. API's initial recommendation was for the Commission to mandate actual rate decreases (1% annually for 20 years) if it decided to approve the acquisition.

As the proceeding progressed, API did extensive financial and policy analysis in support of its position, concluding that under most reasonable scenarios CalAm would suffer substantial, albeit declining, losses under the Application sharing proposal in the near and mid-term. Those losses, due largely to CalAm's proposal to forego general rate increases through 2005 (the so-called "stayout benefits"), might or might not be overcome by the substantial and increasing benefits CalAm would reap in the much longer term. That would subject ratepayers to a double risk: a financially-weakened CalAm possibly less able to maintain adequate service levels; and a CalAm with "a huge incentive to work the Commission hard for the highest synergies savings estimates possible," upon which future rates would be based. API thereupon shifted to suggesting as a solution, "[T]he Commission should consider restructured deals here that include greatly reduced acquisition premia," and that the acquisition as proposed should be rejected.⁶

During the evidentiary hearings, API devoted considerable time and effort to drawing out of CalAm the details and assumptions underlying the synergies analysis and Application sharing proposal. Surfacing those details

⁶ API's analysis was done both before and after the San Jose Water merger application was abandoned. API concluded that dropping the San Jose Water merger application had improved CalAm's prospects, but not sufficiently to change its recommendation.

and assumptions, which had not been developed elsewhere in the record in a consistent and understandable way, proved critical in analyzing whether the acquisition and sharing proposal should be approved.

After CalAm presented the alternative sharing proposal very late in the proceeding, API did more analysis that led it to lend its qualified support, and at the same time to suggest a counterproposal. According to API, “[R]atepayers will get substantial value in any event from the [alternative sharing proposal], albeit only about half of what they would receive under traditional [*i.e.*, non-Sections 2718 through 2720 ratemaking] treatment.” API continued, “[R]atepayers and CalAm carry substantial risks here, while Citizens does not.” Nonetheless, “While this fact makes the deal still unbalanced, the fact that ratepayers now get comparable benefits [to Citizens] and CalAm does not expect a material loss from it may make it an acceptable deal.” And on brief, API concluded, “The acquisition proposed here satisfies the criteria of §§854(b) and (c)...”, and, “The acquisition proposal is in the public interest, considering all relevant factors.”

No party supported API’s counterproposal which we will describe below but not entertain further. CalAm on brief did find merit in one element of API’s counterproposal, however. CalAm agreed that it may be possible to determine and finalize a synergies savings amount in the 2004 general rate case and use it to fix the future acquisition-related revenue requirements and sharing amounts without need for reconsidering them in each ratesetting proceeding over the 40-year amortization period.

Office of Ratepayer Advocates

The Commission’s Office of Ratepayer Advocates (ORA) recommends the Commission deny Applicants the authority to transfer Citizens’ assets.

ORA would have the Commission apply the requirements of Section 854(b) and (c) to this acquisition. Among other things, Section 854(b) calls for ratepayers to receive not less than 50% of the short-term and long-term forecasted economic benefits of the proposed acquisition.⁷ ORA also advocates a standard that any merger or acquisition must deliver “substantial and tangible benefits to ratepayers immediately and over the long term.”

In this case, much of the quantifiable benefit to ratepayers takes the form of so-called “stayout benefits,” which CalAm estimates arise from its offer to forego general rate increases through either 2005 (in the Application sharing proposal) or 2002 (in the alternative sharing proposal). ORA discounts stayout benefits entirely or almost entirely for the alternative sharing proposal on the grounds that they are “illusory”: the time to file for those increases has passed, and there is no evidence that even if CalAm had filed it would have received the rate increases upon which the assumption of stayout benefits rests. Further, ORA discounts in large part any non-quantifiable benefits the acquisition might produce. Thus, ORA believes CalAm’s proposal would essentially guarantee it recovery of its acquisition premium while ratepayers would receive far less than 50% of the benefits and would be at risk of getting no benefits whatsoever.

According to ORA, the Commission should not depart here from its longstanding practice that shareholders be held exclusively responsible for any premium paid above book value. CalAm and its corporate parent, American, are motivated to make the acquisition to maintain American’s

⁷ §§854(b) and (c) are further described and discussed in the Standard of Review section to follow.

competitive position in a rapidly consolidating international market, and Citizens' parent has already irrevocably decided to sell its various water companies to concentrate its efforts in the telecommunications industry. The Commission should determine that neither participant needs a sharing incentive to complete the transaction.

Further, ORA objects to Applicants' proposal to include and recover as part of the acquisition premium their \$1.2 million in acquisition-related costs.

Montara Sanitary District

Montara Sanitary District (MSD) focused entirely on Citizens' Montara District on the San Mateo County coast. MSD does not oppose the acquisition and transfer *per se*, but opposes approval on the terms and conditions Citizens and CalAm have proposed. According to MSD, Montara residents have endured service deficiencies for years despite numerous Commission decisions ordering Citizens to increase its water supply, develop new wells, and rehabilitate its system. The approach the Commission has taken to these problems to date has not worked and will not work for the future. Further, CalAm and Citizens have failed to demonstrate that the acquisition will result in just and reasonable rates for Montara District ratepayers.

MSD would have the Commission condition approval on the following: (1) Citizens should allocate a reasonable portion of the acquisition premium to paying for such capital expenditures as the Commission may determine necessary in A.00-10-049;⁸ (2) CalAm should explore the feasibility

⁸ MSD, CalAm and Citizens are parties in the cited proceeding, in which Citizens seeks approval of its Water System Master Plan Update for Montara District.

and rate impacts of consolidating districts and regionalizing rates across CalAm and Citizens districts in A.00-10-049; (3) CalAm should explore with MSD cost-effective and reasonable means for increasing Montara District's water supply, including joint participation with MSD in water transfers and wholesale water supply purchases; and (4) CalAm should join as a member and participate in any groundwater management district that may be established, and include the Montara District geographic area.⁹

If the transfer is approved without the conditions MSD recommends, Citizens will depart with its sizable acquisition premium, leaving Montara ratepayers no recourse against Citizens. Citizens will no longer have any responsibility for Montara District and no responsibility for implementing whatever improvements the Commission may find required after hearings in A.00-10-049.

Other Parties

Several other parties entered appearances in the proceeding and participated to varying degrees.

San Jose Water and its holding company, SJW Corp., are applicants in A.00-05-016 and co-represented by the same counsel representing CalAm. They participated fully in evidentiary hearings until early-March when

⁹ MSD's conditions shifted somewhat between its evidentiary showing and its brief. This summary is from MSD's brief; a more extensive list assembled from both its brief and direct showing is addressed later in this order.

motions were filed to withdraw the application. Although technically parties in the consolidated proceeding to the end, they did not file briefs or participate in any way in A.00-05-015 after filing their motion.

Three employee unions appeared and participated actively in opposition to A.00-05-016, the CalAm/San Jose Water merger application, until early-March when those applicants filed to withdraw. Utility Workers Union of America, Local 259; Utility Workers Union of America, Local 511; and Utility Workers Union of America, AFL-CIO (the national union) were jointly represented by the Region 5 Director of Utility Workers Union of America, AFL-CIO, and in his absence by the President of Local 259. The unions stated no position on the CalAm/Citizens acquisition Application, and did not participate after the motions to withdraw A.00-05-016.

Operating Engineers Local Union No. 3 of the International Union of Operating Engineers, AFL-CIO, which represents certain employees of San Jose Water, filed a Petition to Intervene in A.00-05-016 and was granted party status on August 17, 2000. It did not participate further in the proceeding.

Representatives of Santa Clara Valley Water District made an appearance at the prehearing conference in A.00-05-016 but did not subsequently participate.

The Proceeding

Both applications were filed on May 16, 2000. The Commission preliminarily determined both to be ratesetting proceedings expected to require evidentiary hearing. Separate prehearing conferences were held in San Francisco on June 22, 2000. Assigned Commissioner Carl Wood issued his scoping rulings on August 2, 2000, confirming the category and need for hearing, and designating assigned ALJ James McVicar as the principal hearing officer and thus the presiding officer in both applications.

On August 17, 2000, ALJ McVicar issued two rulings requiring both sets of applicants to prepare exhibits demonstrating how the applications were in the public interest with respect to each Section 854(c) criterion; granting ORA motions for additional time to serve testimony; modifying (but not extending) the schedules; and granting applicant motions for protective orders.

The ALJ held public participation hearings on September 12, 2000 in San Jose for A.00-05-016, and in Felton, Montara, Santa Rosa and Citrus Heights on successive evenings between September 18 and September 21, 2000 for A.00-05-015.

Thirteen days of evidentiary hearing were held in November and December, 2000, with the applications being consolidated by ALJ ruling on November 20, 2000 after the first week of hearing in A.00-05-015.

On January 5, 2001, ALJ McVicar and the assigned ALJ in A.00-10-049 issued a joint ruling denying MSD's motion to consolidate A.00-05-015 and A.00-10-049.

Thirteen days of further evidentiary hearing were held January 8 through April 10, 2001. On February 20, 2001, the assigned Commissioner and assigned ALJ issued a joint ruling revising the schedule. The proceeding was submitted on receipt of reply briefs due May 14, 2001. During the briefing period, ORA filed a Request for Final Oral Argument before the Commission, and later formally withdrew it.

The Proposals

The Application Sharing Proposal

Section 2720(a) provides, "The commission shall use the standard of fair market value when establishing the rate base value for the distribution system of a public water system acquired by a water corporation." However,

under Section 2720(d), “Consistent with the provisions of this section, the commission shall retain all powers and responsibilities granted pursuant to Sections 851 and 852.” Section 851 requires Commission approval before a public utility may sell any part of its plant, system or other property necessary or useful in providing utility service. Thus, the Commission retains its authority to review a proposed sale and acquisition such as CalAm and Citizens propose in A.00-05-015, and to deny Applicants the authority they seek if the application of Section 2720(a) were to render the proposal not in the public interest.

The Commission has previously observed¹⁰ that “[N]either [§2720(a)] nor any other portion of the [Public Water System Investment and Consolidation Act of 1997] expressly requires an applicant to request such a rate base valuation or prohibits an applicant from seeking a lower rate base valuation in its application or as a product of settlement with other parties.” If an applicant believes that proposing an alternative ratemaking arrangement to Section 2720(a) would help convince the Commission that an acquisition is in the public interest, it is free to do so. Applicants have made an alternative proposal to implement Section 2720 in A.00-05-015.

The Application sharing proposal is set forth in the body of the Application, and in Exhibit 16 attached to the Application which lists some 36 related requests in six categories. The requests in the Application and Exhibit 16 are frequently repetitive and sometimes contradictory, but shorn of detail and simplified, the major elements essential to understanding the ratemaking implications are distilled and listed below:

¹⁰ Decision (D.) 99-09-030 at Footnote 3.

- a. CalAm would book the purchase price premium over net book value of the assets as an acquisition adjustment to be allowed for ratemaking along with rate base, thus meeting the requirement of Section 2720(a).
- b. CalAm would amortize the acquisition premium, estimated at \$64.553 million, on a mortgage-style basis (*i.e.*, equal annual amounts covering principal and a return on the unamortized balance) over 40 years beginning when the acquisition is consummated. The premium would be spread company-wide “to all CalAm post-consolidation Divisions based on the lower overall revenue requirement as a percentage of the total pre-consolidation revenue requirement” [sic].
- c. CalAm’s Los Angeles Division general rate case (GRC) then getting underway (rates to be effective January, 2001) would be processed with no consideration of the proposed Citizens acquisition.
- d. CalAm would defer filing a further GRC for any division, including Citizens Division, until January 2005, at which time it would file a company-wide GRC for rates to be effective January 1, 2006. This is the so-called stayout period.
- e. These GRC deferrals notwithstanding, CalAm would still file for limited rate relief during the pre-2006 stayout period for a wide variety of expense, rate base and cost of capital items as set forth in the Application.
- f. CalAm would retain all synergies savings produced until the 2006 company-wide GRC rates took effect.¹¹ To the extent those pre-2006 savings were less than needed to cover the acquisition premium amortization amount, CalAm would suffer the loss; to the extent they exceeded that amount, CalAm would realize the gain.

¹¹ The Application is contradictory on this aspect, at one point proposing to share any pre-2006 amount in excess of the amortization amount, 5% going to ratepayers. (Application Tab 16, Items C.8 and C.9).

- g. In the 2005 company-wide GRC, the Commission would determine the synergies savings from the acquisition using the 2005 operating results compared to corresponding pre-consolidation baseline figures projected to 2005. The pre-consolidation projections would be extrapolated from the Commission's earlier determinations of the cost of service for the most recent test year in each CalAm division (including Citizens Division).
- h. Beginning in 2006, rates for all divisions would be set to recover CalAm's actual post-consolidation revenue requirements (not including the acquisition premium amortization), plus an adder representing the Commission-determined synergies savings escalated to that year. Depending on whether the adder would be less than or greater than the amount CalAm requires to cover the acquisition premium amortization amount for that year, CalAm would suffer 100% of the shortfall or give a 5% share of any excess to ratepayers.¹² Amortization shortfalls would not be carried forward to be recovered in future years. The Application is ambiguous as to whether the synergies adder would expire when the acquisition premium was fully amortized after 40 years or continue to flow 95% to CalAm in perpetuity, but it is likely the intent was for the adder to expire and ratepayers to receive 100% of the synergies benefits thereafter.

Modifications During Hearings

The Application sharing proposal evolved during the course of evidentiary hearings through CalAm's rebuttal and cross-examination testimony and exhibits. While most of the basic concepts of the Application sharing proposal listed above endured, CalAm greatly expanded the level of detail underlying those concepts and declared that some of those previously

¹² In practice, ratepayers' estimated 5% share would reduce the adder in that same year.

unrevealed details would be considered essential and binding should the

Application sharing proposal be implemented. Here are some of the highlights:

- a. CalAm produced for the first time a list of categories for grouping synergies items, and suggested calculation methods, for determining the synergies adder in 2005 and after. The latter included, *e.g.*, a fixed method for calculating savings due to cost of capital synergies.
- b. It began to suggest for the first time that the Commission would necessarily quantify in this proceeding once and for all some of the pivotal figures for calculating the actual synergies adders over the 40-year amortization period. As presented earlier in the Application, all actual quantification would take place in the 2005 company-wide GRC.
- c. It presented a stipulation proposal related to the synergies model, interim rate filings and other issues. That proposal adjusted the interim rate case filing schedules from what they had been in the Application; stated a simplified and possibly somewhat different version of what items would qualify for such interim rate increases; introduced a standard schedule to be followed in processing the interim increase rate cases; and introduced for the first time a series of figures, methodologies and procedures which it would consider binding on the parties and Commission in future years once accepted. CalAm later added yet additional detail to the proposed synergies calculation methods in the proposed stipulation. The stipulation proposal at this point still reflected cross-synergies generated by the pending CalAm/SJW merger.
- d. The stipulation proposal was subsequently revised to account for abandonment of the CalAm/SJW merger application. Transaction costs for the CalAm/Citizens merger to be included in the acquisition premium were said to be \$1.2 million.
- e. CalAm clarified that it did not intend to allocate to ratepayers 5% of the synergies savings in excess of the annual amortization amounts during the pre-2006 period.
- f. CalAm revealed that because it would be acquiring Citizens' assets, liability for historic advances would remain with

Citizens¹³ and CalAm would not be recording historic advances and contributions on its books. To ease the transitional effect on rates, CalAm would initially treat those advances and contributions as a rate base deduction for ratemaking purposes in the Citizens Division, to be ratably restored over 20 years.

- g. CalAm suggested for the first time that the synergies determined in the 2005 company-wide GRC and escalated to future years could be subject to challenge and revision should circumstances change, with the challenging party having the burden to prove that synergies escalated from earlier years were not still valid.

The Alternative Sharing Proposal

At the March 30th evidentiary hearing, with the intervenors unswerving in their opposition and API having produced much critical analysis of the Application sharing proposal as modified, CalAm introduced an alternative sharing proposal.¹⁴ Many of the elements remained the same as in the Application sharing proposal and the modified sharing proposal. Highlights of the changes are listed below:

- a. Mortgage-style amortization of the acquisition premium would begin in 2002 and run for 40 years.
- b. The general rate case stayout period would be eliminated going forward.¹⁵

¹³ Liabilities for advances and contributions incurred after December 1, 2000 might be treated differently, pursuant to an amendment to the Applicants' Asset Purchase Agreement. (RT1753).

¹⁴ The alternative sharing proposal is set forth in Exhibits CACU-53 and CACU-55.

¹⁵ Even though CalAm would not forego filing future GRCs as it proposed to do in the Application sharing and modified proposals, it nonetheless claims here as stayout benefits to customers \$3.5 million in 2001 and \$4.5 million in 2002, almost entirely due to Citizens' not having filed a GRC in 2000 for rates to become effective in 2001. Instead, CalAm's Citizens Division would file in 2002 for rates effective in 2003.

- c. Since there would no stayout obligation going forward, the list of interim rate filing exceptions to the stayout provision would no longer be needed.
- d. The GRC filing schedule would be:
 - (1) Citizens Division GRC filed in January, 2002 for rates effective for test years 2003 and 2004.
 - (2) Citizens Division GRC filed in January, 2004 for rates effective 2005.
 - (3) Monterey Division and General Office GRCs filed in January, 2002 for test years 2003 and 2004 and attrition year 2005.
 - (4) Los Angeles and Village Division GRCs filed in January, 2003 for rates effective 2004.
 - (5) Coronado Division GRC filed in January, 2004 for rates effective in 2005.¹⁶
- e. CalAm would prove its claimed synergies savings in the 2002 GRC filing, and the Commission would review them again in the 2004 GRC filing to ensure they still existed. Thereafter, they would be carried forward using agreed-upon escalation methods and factors. CalAm would carry the burden of proving that any new or increased GRC expenses (excluding those due to inflation and customer growth) in future years were not erosions of earlier-estimated synergies.
- f. CalAm would retain all synergies savings produced through 2004.
- g. CalAm would begin sharing the synergies savings in 2005 and running until the 40-year amortization period ends. As in the Application sharing proposal, synergies savings would first go to CalAm to the extent needed to cover that year's acquisition premium amortization amount. Again depending on whether the synergies savings adder would be less than or greater than

¹⁶ Exhibit CACU-53, CalAm's primary exhibit describing the alternative sharing proposal, calls for filing a GRC for Coronado in 2004 for rates effective in 2005. Exhibit CACU-55 and CalAm's opening brief call for that Coronado GRC filing to be in 2003.

the amount CalAm required to cover the acquisition premium amortization amount for a given year, CalAm would suffer 100% of the shortfall or give ratepayers a 90% share of any excess (up from 5% in the Application sharing proposal). Amortization shortfalls would not be carried forward to be recovered in future years. At the end of the 40-year amortization period, all subsequent synergies savings would go to ratepayers.

- h. Historic advances and contributions would continue to be treated as described above for the Application sharing proposal as modified.

Under this alternative sharing proposal, CalAm projected that ratepayers would receive \$569 million in benefits over the 40-year amortization period, representing 91% of all benefits in excess of CalAm's return of and on the acquisition premium. Depending on the discount rate, CalAm equated this to between \$51 million and \$80 million in net present value.

The API Counterproposal

On the next to last day of hearing, API introduced a sharing counterproposal of its own. In very brief testimony describing it, API characterized the counterproposal as being built on CalAm's alternative sharing proposal and assumptions. Little else is known of it beyond a spreadsheet column showing the annual figures it would produce as the acquisition amortization amounts over the 40-year period. API did not further define and support its counterproposal in the evidentiary record because hearings were drawing to a close.

Although API's counterproposal is incomplete and was not supported by any other party, CalAm did find in it some redeeming elements. We repeat here CalAm's observations of it on brief on the chance that the parties may find merit in developing those elements in a future sharing proceeding should the acquisition be consummated:

[API's counterproposal] contains certain constructive elements, designed to facilitate administrative efficiency and ratemaking certainty....

* * *

As CalAm understands the API proposal, it would fix the allowable revenue requirement associated with the acquisition premium and sharing of the synergies savings (based on API's schedule) during the 40-year period in this proceeding. It would not require CalAm to prove or the staff or Commission to review whether the synergies levels determined in that manner continue to exist in rate proceedings throughout the 40-year life of the proposal.

API's counterproposal was insufficiently developed on the record to be considered further here.

Discussion

Purchase Price, Acquisition Adjustment, and the Importance of § 2720

As an incentive to water companies to achieve economies of scale through consolidation, the Legislature has added Section 2720(a) to the Public Utilities Code: "The commission shall use the standard of fair market value when establishing the rate base value for the distribution system of a public water system acquired by a water corporation. This standard shall be used for ratesetting."¹⁷ Historically, at the Commission's discretion, any premium paid

¹⁷ §2718. This chapter shall be known and may be cited as the Public Water System Investment and Consolidation Act of 1997.

§2719. The Legislature finds and declares all of the following:

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by a water company for assets in excess of their book value was borne by shareholders in the form an acquisition adjustment to be recorded below the line

(a) Public water systems are faced with the need to replace or upgrade the public water system infrastructure to meet increasingly stringent state and federal safe drinking water laws and regulations governing fire flow standards for public fire protection.

(b) Increasing amounts of capital are required to finance the necessary investment in public water system infrastructure.

(c) Scale economies are achievable in the operation of public water systems.

(d) Providing water corporations with an incentive to achieve these scale economies will provide benefits to ratepayers.

§2720. (a) The commission shall use the standard of fair market value when establishing the rate base value for the distribution system of a public water system acquired by a water corporation. This standard shall be used for ratesetting.

(1) For purposes of this section, "public water system" shall have the same meaning as set forth in Section 116275 of the Health and Safety Code.

(2) For purposes of this section, "fair market value" shall have the same meaning as set forth in Section 1263.320 of the Code of Civil Procedure.

(b) If the fair market value exceeds reproduction cost, as determined in accordance with Section 820 of the Evidence Code, the commission may include the difference in the rate base for ratesetting purposes if it finds that the additional amounts are fair and reasonable. In determining whether the additional amounts are fair and reasonable the commission shall consider whether the acquisition of the public water system will improve water system reliability, whether the ability of the water system to comply with health and safety regulations is improved, whether the water corporation by acquiring the public water system can achieve efficiencies and economies of scale that would not otherwise be available, and whether the effect on existing customers of the water corporation and the acquired public water system is fair and reasonable.

(c) The provisions of subdivisions (a) and (b) shall also be applicable to the acquisition of a sewer system by any sewer system corporation or water corporation.

(d) Consistent with the provisions of this section, the commission shall retain all powers and responsibilities granted pursuant to Sections 851 and 852.

for ratemaking purposes. Section 2720 changed that for California's regulated water utilities, in effect requiring ratepayers to include this acquisition adjustment in ratesetting rate base. All else being equal, if the Commission were to approve an acquisition at a price above book value of the assets, adding the acquisition adjustment to rate base would result in higher rates following the transfer. The Legislature anticipated that the Commission would review each proposed regulated water system transfer as it is required to do under Sections 851 *et seq.* to ensure each is in the public interest before approving it.

In this acquisition Application, American Water Works has agreed to pay Citizens Utilities Company \$835 million for all of Citizens Utilities' regulated and unregulated water and wastewater assets, located in California and five other states. They have allocated the total purchase price to the six states involved in proportion to Citizens Utilities' gross water and wastewater plant in each state. California's share (19.32%) is \$161.32 million. After taking into account the book value of Citizens' assets and the portion of the premium attributable to unregulated assets, the parties generally agree the acquisition premium for California regulated assets would be \$64.553 million. This figure would be adjusted if market value of the non-regulated assets were higher at the time of closing.

Since CalAm proposes an alternative ratemaking method, the Section 2720(b) provision regarding market value in excess of reproduction cost is not at issue.

CalAm maintains that the acquisition and transfer of Citizens' assets would create significant economies of scale, both quantifiable (the synergies savings) and otherwise. It recognizes, however, that if it were to include the full acquisition premium directly in rate base at the time of transfer under Section 2720(a), the revenue requirement for the former Citizens districts would be

driven up and rates would follow in the short term. Economies of scale would begin to develop almost immediately, however, and after the early years the synergies savings from consolidation would overcome the effects of including the acquisition adjustment in rate base. Rates could then begin to drop to below what they would have been for the stand-alone operation.

We have previously found that the Commission lacks discretion to condition approval of a water utility merger upon valuation of rate base of the acquired system below fair market value.¹⁸ The same reasoning applies to the acquisition and transfer here. Applicants are acutely aware that should the Commission decide that an acquisition with a short-term, significant increase in rates is not in the public interest despite the promise of longer term ratepayer benefits, it would not be approved. However, if an applicant believes that proposing an alternative ratemaking arrangement that is still compliant with Section 2720(a) would help persuade the Commission that an acquisition is in the public interest, it is free to do so. CalAm made such a proposal in A.00-05-015, and shortly before the close of hearings presented an alternative sharing proposal. Since no party has taken issue with CalAm's claim, with which we agree, that the alternative sharing proposal is more favorable for ratepayers than the Application sharing proposal, we will confine our consideration to the alternative sharing proposal for the remainder of this decision.

Standard of Review

Applicants, ORA and API expended considerable effort before and during evidentiary hearings and on brief disputing what legal standard should properly apply in this proceeding. While we will summarize their positions, we

¹⁸ D.99-09-030, Dominguez Water Company.

find CalAm's alternative sharing proposal to be in the public interest regardless of which of two standards we might have chosen: "no harm to ratepayers," or "equitable sharing of benefits."

CalAm argues that the Commission has always used a "no harm to ratepayers" standard of review for proposed acquisitions, and that it remains the standard that must be applied today notwithstanding dissenting and concurring opinions to the contrary in several recent decisions.¹⁹ Further, Applicants claim that even if a "positive ratepayer benefits" standard were used, their proposals would meet it. In their reply brief, they state,

Applicants acknowledge that the Commission has broad discretion to review acquisitions to determine whether or not they are in the public interest [under §§ 851 and 854(a)]. It is well established that the overriding principle governing Commission decisions, whether in the context of an acquisition proceeding, or any other type of proceeding, is whether the requested relief is in the public interest. However, CalAm does not agree with Staff's assertion that the Commission has "virtually unlimited discretion" under §§ 851 and 854(a) to approve or deny water utility acquisitions.

ORA on brief discusses the standard to be applied without stating concisely what that standard should be. ORA notes the same dissenting and concurring opinions calling for a "positive ratepayer benefits" standard as does CalAm, coupling those with Section 854(b)(2) and the Commission's reference to that section in D.97-03-067²⁰ to infer a standard wherein ratepayers must receive

¹⁹ See, *e.g.*, D.00-05-027 and D.00-05-047.

²⁰ In D.97-03-067 (Re: SBC Communications to Acquire Pacific Telesis Group), the Commission stated, "Section 854 requires that we allocate "no less than 50 percent" of economic benefits of the merger to ratepayers. We interpret this to mean that ratepayers must receive at least 50% of the economic benefits of the merger and that the

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no less than 50% of the economic benefits of the transaction. ORA does acknowledge that Sections 854(b) and 854(c)²¹ do not by their terms apply to water companies, but would still apply them here. In evidentiary hearings, its position was that the Application should be denied because it did not provide “substantial and tangible benefits to the ratepayers immediately and in the long term.”

API states its recommendation as:

The standard of review should require at least satisfaction of two criteria: 1) that the proposed acquisition be found to be in the public interest in the sense of providing net social benefits; and 2) that the affected ratepayers reap substantial, immediate and continuing quantifiable net benefits proportional at least to the risks they carry relative to the net benefits and risks carried by affected utility stockholders.

API would recognize the Section 854(b) and (c) criteria as generally very useful for review purposes, but would not embrace the Section 854(b)(2) 50% sharing threshold where the Commission is not statutorily required to do so.

We find that a transaction subject to Section 2720 should offer to ratepayers some equitable share of the benefits the transaction will generate. This is entirely consistent with Sections 2719(c) and (d) in which the Legislature found and declared, “Scale economies are achievable in the operation of public water systems,” and “Providing water corporations with an incentive to achieve these scale economies will provide benefits to ratepayers.” Reflecting an “equitable sharing of benefits” standard does not speak to whether those benefits

Commission has the discretion to allocate the remaining 50% between ratepayers and shareholders as specific circumstances warrant.”

²¹ See the passage on Section 854(c) criteria below for further explanation of that section.

should be entirely quantifiable, entirely non-quantifiable, or some combination of both.

Applying Section 2720 places a cost on ratepayers: that of supporting a rate base higher than it would otherwise be because it is set at fair market value. CalAm's Section 2720-compliant alternative sharing proposal similarly places a cost on ratepayers: that of paying through rates a return of and on the acquisition premium. Ratepayers are not only at risk that synergies will not exist or will not be as great as CalAm estimates them today to be, but that even if they do exist they may be eroded in the future, or an imperfect ratesetting process applied over a 40-year period may overestimate their magnitude and thus provide an excessive sharing amount to CalAm at ratepayers' expense. CalAm, however, represents its alternative sharing proposal as providing benefits to ratepayers that more than offset all costs it places on them from whatever source.²² It is that claim that we must weigh here: Does CalAm's alternative sharing proposal provide to ratepayers an equitable share of the anticipated benefits given the costs and risks imposed on them? Only if it does will we find the acquisition to be in the public interest and approve it.

Ratepayer Benefits

Quantifiable Synergies

As part of the application process, CalAm prepared a study to demonstrate the quantifiable economies of scale it expects to bring about should

²² CalAm may argue that there are no risks to ratepayers because it proposes that there will be no increases attributable to the revenue requirement of the acquisition premium that exceed the savings produced. That might be true if ratesetting were an exact process. It is not, and the more so when extrapolating estimated quantities decades ahead. Thus the ratepayers' risks are real and may be quite significant.

it acquire Citizens and merge with SJW. An updated version was introduced at the first day of hearings, and a further update which also removed the effects of the abandoned CalAm/SJW merger proposal was introduced later. CalAm is confident that the synergies savings shown are minimum amounts to be generated, that the assumptions built into the synergies analysis are conservative, and that with actual experience in operating the combined assets even greater synergies will be realized.

The synergies analysis quantified CalAm's expectations for reductions due to, *e.g.*, duplicated executive, management and operating personnel positions and expenses, avoidable expenses and material costs, use of existing employees and equipment to replace purchased services, cost of capital reductions, and future reductions below historical cost trends. In response to an ALJ request, CalAm presented an exhibit comparing customers' revenue requirement savings over the 40-year amortization period in total dollars and net present value (NPV) for three ratesetting methods, using as discount rates both CalAm's net weighted cost of capital (8.43%) and gross weighted cost of capital (11.95%).²³

Table 1

	Applicants' Alternative Sharing Proposal	\$2720 Return On Only	\$2720 Return Of and On
Customer Savings through 2041	\$569,613,231	\$557,859,892	\$659,201,253

²³ The data underlying Tables 1, 2 and 3 are based on differing assumptions from one table to the next, depending on which party prepared them and when. Thus, caution should be used in comparing specific figures from one table to another. These differing assumptions do not, however, materially change the *qualitative* conclusions to be reached from the tables.

NPV at 8.43% Discount Rate	\$ 83,143,562	\$ 67,844,149	\$ 72,819,546
NPV at 11.95% Discount Rate	\$ 48,124,886	\$ 34,689,615	\$ 34,164,982

The first column shows CalAm's view of the effect on customers of its alternative sharing proposal; the second the effect on customers if the Commission were to follow Section 2720 directly, by using fair market value as rate base (allowing a return on the acquisition adjustment); and the third again following Section 2720 but allowing both a return of and on the acquisition adjustment.

Although the parties differed on the proper discount rate and other assumptions, each would agree that in the end the choice did not affect their conclusion. Using CalAm's synergies assumptions, following Section 2720 and allowing a return of and on the premium produced the greatest reduction in revenue requirement for customers when measured in total dollars. When the time value of money is recognized, however, CalAm's alternative sharing proposal would be best for ratepayers.

CalAm prepared another exhibit (using slightly different assumptions) to make its point that its alternative sharing proposal would give ratepayers a significant proportion of the total synergies savings:

Table 2

	Total Synergies Benefits (through 2041)	Benefits to Ratepayers	% to Ratepayers
Total \$	\$853,397,002	\$569,613,407	67%
NPV at 8.64% Discount Rate	\$147,394,039	\$ 80,155,174	54%
NPV at 11.48% Discount Rate	\$101,239,045	\$ 51,363,429	51%

While ratepayers would receive a benefit equivalent to 67%, 54%, or 51% of the synergies savings in this comparison, the remainder would go not to

CalAm, but rather to CalAm and Citizens together, with Citizens getting nearly all. API's final exhibit made this point clear in Table 3 that follows.

ORA initially took issue with much of what was presented in CalAm's synergies analysis. It later came to closure with CalAm on its late-proceeding estimate of achievable synergies, agreeing that estimate is appropriate for the purpose of evaluating the acquisition. Apparently relying largely on CalAm's synergies analysis and its own net present value calculations, ORA estimated that under CalAm's alternative sharing, ratepayers could receive about 43% and Applicants 57% of approximately \$101 million in net present value attributable to the acquisition. ORA concluded that the share offered to ratepayers was inequitable and/or not sufficient to overcome the risk that the projected synergies may not materialize, and recommended the Application be denied. ORA did not present a quantitative analysis that addressed what an equitable allocation of the benefits due to the synergies in this case would be. ORA also objected to CalAm's proposal to include and recover as part of the acquisition premium \$1.2 million in acquisition-related costs. CalAm responded that, just as its payment of fair market value is necessary to acquiring the assets that generate the shareable synergies, so is incurring the acquisition-related transaction cost. CalAm would be making an investment that will benefit both it and its ratepayers, an investment it should be allowed to recover from the benefits. Were CalAm constructing a new system or making plant additions, the long accepted practice would be to capitalize and recover in rates all of the related costs. The situation here is analogous.

API prepared its own comparison to show the distribution of all quantifiable benefits to be realized through the acquisition under CalAm's alternative sharing proposal, doing so in such a way as to show the effects on all three stakeholders: ratepayers, CalAm and Citizens. After making a series of

adjustments to incorporate its own assumptions, including inflation, escalation and discount rates, stayout benefit allocation, cost of capital, and terminal values of benefits beyond 2041, API tallied the range of effects on the three stakeholders it expected depending on the discount rate chosen:

Table 3

	Ratepayers	CalAm	Citizens	Total
NPV of Total Net Benefits	\$41,000,000 to \$75,000,000	(\$2,000,000) to \$ 0+	\$61,000,000	\$100,000,000 to \$136,000,000
% of Total Benefits	41% to 55%	(2%) to 0%+	45% to 61%	100%

CalAm's near-neutral outcome in this summary is driven by the very large premium over asset value it has agreed to pay to Citizens. During the final days of hearing, CalAm's witness testified that it chose the 90%/10% split of any savings in excess of the annual acquisition premium amortization as being the minimum share that would allow it to break even on its purchase premium over the 40-year period. That is consistent with API's Table 3. With respect to the effect on CalAm and the relative sharing between CalAm and Citizens, we agree with API: "As both Applicants are fond of noting, the deal was negotiated at arm's length between willing parties, each under no compulsion to do it, and thus the Commission need not agonize over the distribution of net benefits and risks between [them], unless it threatens the financial viability of one or the quality of service relative to rate levels, neither of which it does."

API was the most active intervenor in examining CalAm's synergies analyses and distributions of benefits. While still expressing reservations with CalAm's assumptions of growth, inflation, escalation and discount rates, and terminal values, API also in the end agreed that any one of the three sharing scenarios in Table 1 "would involve ratepayers sharing more or less half of the

benefits with the stockholders in the Applicants, and they still yield substantial net benefits to ratepayers over continued separate operation.”

Thus, CalAm and API, both of whom performed credible, independent analyses of the relative distribution of the benefits, agree that ratepayers stand to receive roughly half of the net benefits generated by the acquisition.

Stayout Benefits

The largest share of the quantifiable benefits from the Application sharing proposal were said to be about \$25 million in stayout benefits, those benefits arising from CalAm’s commitment to forego filing general rate case applications for increases effective through 2005. Under the alternative sharing proposal, CalAm would forego filing in 2000 and 2001 only. CalAm would file general rate increase applications for its Monterey Division, its general office, and the new Citizens Division in 2002 for rates effective in 2003, following the filing schedule described earlier. For this, CalAm claims in the alternative sharing proposal as stayout benefits to customers \$3.5 million in 2001 and \$4.9 million in 2002, almost entirely due to Citizens’ not having filed a GRC in 2000 for rates to become effective in 2001.

CalAm states on brief that ORA has stipulated that these stayout benefits are real. While the record shows ORA did not stipulate to them, ORA did describe them as “the only guaranteed ratepayer benefit” offered by Applicants’ alternative sharing proposal. On brief, ORA argues that the stayout value CalAm imputes to ratepayers in 2002 is illusory because the time for filing for that increase has passed.

For its part, API recognizes that the stayout amounts claimed for 2001 and 2002 are no longer contingent on our approval of the acquisition, but believes they “can be claimed as an equitable matter as a ratepayer benefit

already conferred as a consequence of the Application in good faith by Applicants.” API thus recognizes the stayout benefits for analytic purposes.

We do not accept that the stayout benefits CalAm claims should be given weight as quantifiable benefits. The specific amounts estimated are entirely speculative. CalAm offers as ratepayer benefits some amounts which are not dependent on whether the Commission approves or disapproves the transfer, or whether the transfer in fact takes place if it is approved. The remainder of those estimated ratepayer benefits rely entirely on conjecture that the Commission would have approved specified revenue requirement increases in general rate cases which may or may not have been filed absent the Application. CalAm itself states that these conjectured benefits “...include [only] those stay-out benefits that inure to the ratepayers due to delays in GRC’s that have already occurred...,” and acknowledges that if this Application were denied, the earliest Citizens could file for a general rate increase would be in 2002 for rates effective in 2003. It is not appropriate to consider the specific dollar amounts of those supposedly foregone revenues as ratepayer benefits for purposes of evaluating CalAm’s proposal. We remain open, however, to recognizing that ratepayers may already be receiving some value, albeit speculative and not reasonably quantifiable, associated with the Applicants’ having filed this Application.

There is approximately \$8 million in stayout benefits included in Table 1, in the Applicants’ Alternative Sharing Proposal column, whether measured in total dollars or discounted dollars.²⁴ The remaining columns in

²⁴ Because these cash flows are said to occur in 2001 and 2002, there would be very little effect of discounting

Table 1 do not anticipate stayout benefits. The Benefit to Ratepayers column in Table 2, and the corresponding percent figures, include similar amounts, while the Total Synergies Benefits column does not. In Table 3, the full \$8 million stayout amount is included in the Ratepayers column, partially balanced by the negative of the 2002 portion, about \$5 million, in the CalAm column and the negative of the 2001 portion, about \$3 million, in the Citizens column. The Total column is unaffected. In each case the stayout adjustments, while significant, do not change the conclusions we reach from those tables. Ratepayers stand to receive a smaller amount if the stayout benefits are disregarded, but still an amount approaching one-half of the net benefits generated by the acquisition.

Rate Effects

In addition to examining likely revenue requirement effects, API presented the only analysis of the data from a different and more revealing perspective: What effect would the different ratemaking methods have on future rates?

As with revenue requirement, API's analysis confirms that after rate spikes during the first two to three years, all three Table 1 ratemaking methods would be superior to the No-Acquisition alternative for the indefinite future. Under one reasonable set of assumptions, rates for the Section 2720 Return On Only and Section 2720 Return Of and On methods would spike the first year after acquisition at 3.5% and 11.6%, respectively, above what they would have been under No-Acquisition. They would then drop steadily to reach a low point at 9% to 11% below No-Acquisition rates in about 2016 through 2019, and thereafter gradually climb back to about 5% below No-Acquisition rates in about 2042.

For CalAm's alternative sharing proposal, rates would remain unchanged from the No-Acquisition rates (or would be lower if one recognized

stayout benefits) through 2004, drop by 5% in 2005 when sharing began, and continue downward until they reached a point 11% below the No-Acquisition rates in 2015, then gradually rise to about 5% below No-Acquisition rates in 2039 and after.

These and other analyses done by API demonstrate that, while the absolute levels of customer savings vary widely depending on assumptions of cost escalation rates, method for spreading the savings to the districts, discount rates, *etc.*, the relationships between the various alternatives remain relatively stable. The result is the same in each case: within a reasonable range of assumptions, customers are significantly better off under any of these ratemaking alternatives than they would be without the acquisition.

Non-quantifiable Benefits

In addition to the considerable quantifiable synergies, Applicants list a series of non-quantifiable and non-monetary advantages to be realized through the acquisition. We highlight some of those here:

- a. Larger companies can bring more resources to bear in emergency situations and natural disasters, and their geographic diversification spreads the risks in case of natural disaster. The former Citizens districts will receive the greater benefit from their association with CalAm and American, the nation's largest investor-owned water system, but CalAm's divisions will benefit in California as well.
- b. The former Citizens districts will benefit from access to CalAm's strong in-house laboratory and water testing capabilities in California, and to American's nationally recognized research laboratory in Illinois.
- c. American and CalAm have management and operational expertise and specialized in-house design and engineering capabilities that would otherwise be unavailable to the Citizens districts today except at very high cost. Those capabilities will be available immediately and in the long term to address needs

in the Montara service area and each of the other former Citizens districts.

- d. The Commission has long welcomed larger water companies' participation in absorbing small, inefficient or troubled systems here in California. Citizens presently has limited capability to contribute; CalAm has historically done so "when such acquisitions made operational sense." With a larger geographic footprint in the state, CalAm predicts it will be increasingly able and inclined to participate in that effort in the future. In addition, CalAm sees for itself an enhanced ability to continue to participate in ongoing industry consolidation, which we interpret to mean large consolidations of the type proposed in this Application and the now-defunct CalAm/SJW merger application.
- e. Potential investors should have a better perception of the larger, combined company, leading to improved access to funding for future infrastructure needs.
- f. Applicants believe the Citizens and CalAm service areas will benefit from the adoption of the best practices of both companies and the combined efficiencies that will bring. For example, CalAm conducts annual customer satisfaction surveys; Citizens does not. CalAm uses the results as a component in determining incentive compensation awards for officers and top-level managers, a powerful tool for improving performance.

This latter topic is of particular interest to us. In an age when competition in the various utility industries is on the rise, we are particularly sensitive to any indication that the providers we regulate may reduce costs by reducing service. One of the conditions MSD would have us place on our approval of the acquisition is, "CalAm should retain the Citizens office in Montara and staff it with adequate personnel and necessary administrative support to provide safe and reliable water service." API echoes the point by recommending a study be submitted on customer cost versus customer benefit of reducing customer-service functions, as a condition of approval here. Indeed,

Applicants do list as a benefit, “a consolidated customer service center that will provide current customers of Citizens with access to their water utility on a 24 hour a day, seven day a week basis, something they do not now enjoy.”

During the evidentiary hearings, CalAm touted as one of the prospective benefits of joining the American Water Works system American’s initiative now in the works to consolidate customer service centers nationwide into a single location. CalAm currently has a regional call center in Chula Vista, California. Although the record is not entirely clear on the point, it appears that Citizens has walk-in customer service available in some or all of its four operating districts in California. CalAm’s witnesses testified at length to the benefits customers will gain through the use of new technologies when local customer contact locations are closed in favor of a single, nationwide center. We have already experienced some of those technologies in operation and heard firsthand customers’ reactions in hearings across the state in other proceedings: ACD (automatic call distribution); CTI (computer-telephone integration); and, infamously, IVR (interactive voice response, which when poorly implemented is frequently dubbed “voice mail jail”). It may well be, as CalAm’s witnesses testified, that these technologies respond to the needs of “a larger and larger base of our population [who] would prefer self-serve options as opposed to interacting directly with a human voice for [routine transactions].”

American’s consolidation to one call center for 23 states may potentially divert the company’s attention from the water service problems of individual districts such as Montara. Reducing or eliminating local walk-in locations for bill paying and other one-on-one contacts are not synergies. On the other hand, CalAm’s call center would handle customer inquiries 24 hours a day, 7 days a week, whereas the business office in Montara is now open 8 hours a day, 5 days a week. Thus, there are balances to be considered. Rather than draw

conclusions at this point, we will simply state that reductions in expenses generated by reducing services are not in themselves synergies and should not be treated as such in any future synergies-determination filings.

Continuing with Applicants' list of non-quantifiable and non-monetary advantages:

- g. Being part of the large, nationwide American system brings to the former Citizens districts significant advantages in employee recruiting and retention; and to employees, enhanced employee development and training, professional growth, and career opportunities.
- h. American's single-purpose focus on the water and wastewater business means the former Citizens districts will not have to compete in-house for resources with other, potentially more lucrative operations in other industries. Those districts are today part of a Citizens family which has gas distribution and electric distribution businesses and a corporate strategy to position itself as a pure telecommunications service provider in the future.

This brings us to a second sensitive topic. Both Applicants have referred on the record to their expectations for the future of Citizens' water operations and customers in California should this transfer not take place. From Citizens' opening statement in the evidentiary hearings:

[The president of Citizens' national public sector and a witness in this proceeding] describes a strategic decision made by the parent at the corporate level. Citizens is simply concentrating its efforts going forward on its telecommunications businesses. What this means in practical terms is that no matter how hard Citizens tries and no matter how closely it works with this Commission in the future, if it cannot sell its water operations in California, over the long run its customers will experience a level of service lower than it otherwise could. Because of Citizens' strategic decision, it will begin to lose the modest scale economies it now enjoys as Citizens disposes of its water operations in other states.

Citizens customers will not receive the benefits that CalAm could offer such as 24-hour customer service call center, a renowned testing facility and other benefits that are described in the testimony of the witnesses. Citizens' customers will not receive the operating synergies described by the witnesses and described by [CalAm counsel] in his opening statement. And finally, Citizens' customers will be receiving service from a less focused service provider. None of this needs to happen.

And Citizens sums up on brief:

If Citizens were to be required to remain in the water business in one or more states, it would be doing so reluctantly and without the kind of commitment necessary to grow the business to achieve the economies of scale that are becoming a requirement.... [I]t would not be sound public policy for this Commission to withhold approval of this transfer. To do so would not only require Citizens to stay in the business in a weakened position, but it would also cause ratepayers to be deprived of the considerable economies provided by a combined Citizens/CalAm entity.

We appreciate Citizens' candor and recognize the real challenges it would face should it succeed in divesting itself of its water operations in other states but not in California. Smaller operators, such as Citizens would be, do have diminished economies of scale. But regardless of its reluctance, should Citizens for whatever reason find itself still a regulated water provider in California in the future, we fully anticipate, and will continue to require, that Citizens have no less than a commitment to provide top quality service at reasonable rates to all of its California water customers.

That said, we do agree that there are many significant non-quantifiable and non-monetary advantages available through this acquisition. We consider them in the aggregate to be a major benefit of Applicants' proposals.

Ratepayer Risks

During the course of the proceeding the opposing parties pointed out various ways the acquisition and CalAm's alternative sharing proposal could expose ratepayers to disadvantage or risk. In this section we review the more significant of those.

Overestimated Synergies

The Application explains that American developed a preliminary analysis of the potential synergies and a discounted cash flow analysis when it decided to proceed with the acquisition in October 1999. It subsequently refined its results and included a summary in the Application. The full study was supplied to the parties as part of the Application workpapers. Both ORA and API evaluated the Application synergies study and found it wanting. ORA's evaluation found "projected savings... significantly lower than those shown in the Application...." In its early direct testimony, API characterized the synergies analysis as "questionable," "simply not credible," and "not... at all realistic," and recommended a guaranteed rate decrease as a condition of approval.²⁵

CalAm has consistently maintained that its synergies estimates are the minimum amounts it will save; it fully expects actual savings to be higher. Under the alternative sharing proposal, realized synergies savings go first to CalAm to amortize the acquisition premium, and second to ratepayers and CalAm in a 90%/10% split. If synergies savings have been wrongly estimated, it is ratepayers who will be first to feel the impact, either positive or negative, through their 90% share. Their risk is limited, however, in that rates under the

²⁵ CalAm's early synergies studies represented each combination of companies: CalAm with both SJW and Citizens, CalAm with SJW, and CalAm with Citizens.

alternative sharing proposal will not increase as a result of any synergies shortfall below the amortization level. CalAm's risk is greater: it may fail to recoup its acquisition premium.

There are at least three ways synergies savings could be overestimated: errors in predictions of what can or will be achieved through economies of scale in operations and capital structure and/or how much value they will produce; errors in estimating the escalation, inflation and discount methods used to extrapolate future benefits and sum them to a present value; and the possibility of long-term, significant changes that defy prediction today.

During the evidentiary hearings CalAm continued to work with the parties to refine its studies, producing at least two updates including one which eliminated all SJW-generated synergies. ORA later agreed that CalAm's late-proceeding estimate of achievable synergies was appropriate for the purpose of evaluating the acquisition. API continued to take issue with CalAm's inflation, escalation and discount rates to the end, but also acknowledged that the quantifiable benefits were real and sufficient to provide the sharing shown in Table 3. Any differences API still had with CalAm's synergies estimates would not change its relative ranking of the alternatives under consideration, including the No-Acquisition alternative. The possibility of long-term, significant changes that defy prediction today will always be with us no matter which alternative we select, and it provides no reason to choose any of them over another.

Actual sharing amounts would be calculated based on new analyses to be performed in the 2002 and later general rate cases. CalAm's latest synergies study is sufficiently reliable for our purposes in this proceeding.

The foregoing ratepayer risks are associated with the possibility that CalAm may have overestimated future synergies savings in this proceeding. Ratepayers are also exposed to a risk that claims may be made in future

proceedings for amounts that are not true synergies savings. To help guide parties in those future proceedings, we state here that only cost savings that clearly could not have been achieved absent consolidation are synergies savings within the meaning of that concept in this proceeding, and only such synergies savings are to be counted in any future synergies-determination GRC filings

Overestimated Stayout Benefits

CalAm estimates ratepayers will receive about \$8 million in stayout benefits during 2001 and 2002. We have already explained our conclusion that Applicants' stayout benefits are speculative, not accurately quantifiable, and not dependent on whether or not the acquisition takes place. Because the benefit relates to Applicants' not having filed general rate cases during 2000 and 2001, and therefore not increasing rates, whatever benefits may exist are now guaranteed to ratepayers, and likely so through all of 2002. Ratepayers are thus not at risk for losing those benefits. Also, since we are not giving weight to a quantifiable effect of stayout benefits, any error in their estimation will have no effect on our decision to approve or not approve the acquisition.

Service Degradation

During the proceeding both ORA and API raised the specter of a CalAm so weakened by losses as a result of this acquisition as to be unable to maintain adequate service levels. Alternatively, it might be an otherwise-strong CalAm so pressed to achieve economies sufficient to cover the premium amortization amounts that it sacrifices service quality in the process. While not abandoning that concern, neither did ORA press it in the later stages of the proceeding. After developing the record regarding the synergies study in depth and producing the Table 3 figures, API did move away from that position.

We believe either service degradation scenario is highly unlikely. First, the parties have convinced us that the synergies to be realized through this consolidation are both real and significant; generating enough synergies to cover the annual premium amortization amount should be well within CalAm's grasp. Second, there is a discontinuity in the sharing function at the point where the synergies savings in any year reach the acquisition premium amortization amount. That is, CalAm will be highly motivated to achieve the first dollars of savings because it will retain 100% of them to cover that year's amortization amount, but it will be much less driven to achieve additional savings because it will retain only 10%; the remaining 90% will go to ratepayers. Thus there is little likelihood CalAm will be either weakened or pressed to the point of sacrificing service quality.

We earlier discussed our view of the possibility, raised by API and MSD, that walk-in customer services in the former Citizens districts could suffer in the quest for synergies. That is indeed something that causes us concern, and something we will want parties to keep us informed about during future CalAm ratesetting proceedings.

Ratemaking Complexity

The ratemaking method CalAm proposed in the Application had a ring of simplicity. Using the most recently decided general rate case results, one would determine a stand-alone ("benchmark") cost of service in each district "by trending that last test year, adjusting for inflation and incorporating unusual, extraordinary or anomalous changes to arrive at a year 2005 benchmark," *etc.* The synergies savings estimates would then be the differences between revenue requirements determined for the various districts in 2005 under consolidated operation and their extrapolated stand-alone costs of service. Many aspects of

the suggested procedure were not well-defined, but the concept was reasonably straightforward.

As the evidentiary hearings progressed, CalAm's Application sharing proposal evolved with the addition of more detail and newly proposed procedures and figures, some but not all of which CalAm said would be binding. Applicants introduced a proposed stipulation exhibit, and later revised it to reflect abandonment of the SJW merger proposal and other updates. The proposed stipulation was characterized as "a comprehensive and complete proposal to resolve the issues related to the Synergy Model." ORA agreed to the stipulation proposal; other parties, including API which was much more active than ORA in developing the record on the substance of the proposed stipulation, did not.

With CalAm's alternative sharing proposal came additional changes that were not reflected in the proposed stipulation.

API pointed out the difficulty of estimating after a consolidation what the benchmark cost of service would have been absent consolidation:

Applicants have suggested that it is easy to [estimate costs for the path not chosen], by merely updating or projecting forward costs that were adopted in a past GRC or by using the projections of their cost-factor-savings models they have employed to estimate the synergies amounts here, but such projections/update language hides a number of very real problems such as reflecting changing market conditions and myriad other factors that impinge upon utility management decisions that would have had to be made after the test year of the last rate case. For all these reasons and others, estimation of synergies savings after they are incurred is quite uncertain, unknown and difficult to measure – and much harder still to project reasonably to the future, even though simple mechanisms such as escalators and indices, etc. are available to make the estimates.

And on brief, API notes,

[T]he implementation process could also lead to unrealistically high initial synergies estimates for ratemaking and indexes that would artificially inflate the initial figures increasingly as time goes by. Second, the implementation process for Applicants' proposal is so complex as to almost insure significant and otherwise avoidable error, and likely mischief and endless unproductive advocacy battles.

ORA on brief also notes this complexity and lack of clarity in CalAm's proposal for determining the synergies savings. We consider this particularly troubling in view of the advantage a utility may enjoy by way of being the keeper of the financial and operating records. Without flexibility, depending on what method of carrying synergies forward were chosen, it might be necessary to track volumes of data for decades, and in that our staff and other parties would be at a disadvantage.²⁶

CalAm repeatedly acknowledged that it would have to carry the burden in future proceedings to demonstrate what synergies have been realized. CalAm also acknowledged that the Commission would be free in the future to examine whether synergies initially realized may have for whatever reason declined with the passage of time to below those initially projected. The stipulation proposal, while not permitted to extend to substantive issues which may come before the Commission in other or future proceedings,²⁷ may prove a

²⁶ CalAm's rate case expert testified it retains complete sets of rate case workpapers for every rate case going back many decades. ORA's records, in contrast, generally run back to the last general rate case, and ORA's project manager testified it would not be feasible to retain more.

²⁷ Rule 51.1(a) provides, "Parties to a Commission proceeding may stipulate to the resolution of any issue of law or fact material to the proceeding, or may settle on a

valuable reference to establish the level of synergies achieved. However, we decline in this proceeding to foreclose parties from proposing and supporting other methods and figures in a future proceeding.

In the end, the record is unclear on just which subset of the many procedures CalAm has described it would have us apply to carry synergies savings estimates into future years; there is no single, consistent source of reference. What is clear is that under the alternative sharing proposal CalAm would carry the burden to prove its claimed synergies savings in the 2002 GRC filing, and the Commission would review them again in the 2004 GRC filing to ensure they still existed. Thereafter, they would be carried forward using rate case standard escalation methods and factors. CalAm would bear the burden of proving that any new or increased GRC expenses (excluding those due to inflation and customer growth) in future years were not erosions of earlier-estimated synergies. We need not attempt to establish or memorialize every detail here. Rather, we have described the framework in this order and will leave it to the parties to advocate and support the details they think work best in the 2002 and/or 2004 general rate cases if the acquisition goes ahead.

This flexible approach will serve to address the opposing parties' cautions regarding the potential for future ratemaking complexity.

Premium Regeneration

Under Section 2720, the Commission must use fair market value when establishing rate base for ratesetting following an acquisition. Here,

mutually acceptable outcome to the proceeding, with or without resolving material issues. *Resolution shall be limited to the issues in that proceeding and shall not extend to substantive issues which may come before the Commission in other or future proceedings.*" [Emphasis added].

CalAm has proposed favorable treatment of the acquisition adjustment as the accounting device that boosts the ratesetting base to approximate fair market value. As ratepayers amortize the acquisition adjustment through rates, they in effect repay to CalAm the capital it has used to finance the acquisition premium plus a return on the unamortized balance. During evidentiary hearings, the ALJ invited parties to address what effect a future resale of the same assets, either before or after the acquisition adjustment is fully amortized, might have. Under Section 2720, might rate base once again be raised to fair market value, regenerating the acquisition premium and wiping out whatever progress ratepayers had made toward paying it down?

It does seem clear that there is at least some potential for portions or all of these assets to be resold in the future. A CalAm witness testified that, while American may be large by U.S. water industry standards, consolidation in the industry has taken on an international scope, driven by the need to achieve ever greater economies of scale. He gave several examples of foreign water companies' having acquired very large U.S. water utilities, and cited those as among the reasons American is pressed to continue to grow. By this reasoning, CalAm or American could in the future be a takeover target. It is also possible CalAm or American could seek to sell parts of their system, including the former Citizens assets, to another provider.

If the Citizens assets were to be resold, what benefit would ratepayers receive from having paid down the amortization adjustment? No party had an entirely satisfactory answer. CalAm's response probably came closest: The acquirer would need Commission approval for the purchase or merger, and the Commission would determine at that time whether the transaction being proposed was in the public interest considering all factors including additional achievable synergies and the new purchaser's proposed

ratemaking treatment. The Commission would decide whether the transaction was in the public interest despite any loss of amortization, and then accept or reject it under Section 851. That answer, while not very satisfying to Citizens and CalAm ratepayers who may by then have contributed tens or hundreds of millions of dollars through their rates to pay down the acquisition adjustment, is probably the best that can be hoped for so long as Section 2720 remains part of California law.

Better Future Offer

ORA argues that Applicants need no incentive from ratepayers to enter into this transaction. Citizens is already irrevocably committed to divesting all of its U.S. water and wastewater operations, and CalAm is motivated to maintain its competitive position in a rapidly consolidating international market. Although CalAm claims to seek only to be made whole as a result of the transaction, ratepayers should not be asked to pick up the tab. While it recognizes the significant synergies this consolidation would bring, ORA recommends denial. Under necessity to sell, Citizens might then agree to accept a lower purchase premium from CalAm or another purchaser in the future, or the subsequent purchaser might allow ratepayers to retain the synergies savings but not require them to compensate it for any purchase premium.

API also explored this line of reasoning and came to the opposite conclusion. “While rejection here could lead these applicants to make improved proposals, or some other purchaser may come forward with a better deal, there is no certainty of either.” Following API’s analysis, “If Applicants stick to their stated and reasonable position that CalAm needs to recover its acquisition premium, then some other [sharing] structure may be devised, but it cannot have a better present worth for ratepayers than do either of the current proposals or

the rate base and amortization option, because [these current proposals] barely cover CalAm's acquisition cost on an expected-value basis."

We believe API is correct here. Relying on data similar to that in Tables 1 and 2, and its own Table 3, API concludes that the ratepayers' share will be more or less half of the net benefits. Given that there are substantial non-quantifiable and non-monetary benefits as well, the Commission should approve the Application rather than risk losing this deal and its substantial expected benefits without reason to believe that a better deal is forthcoming.

§854(c) Criteria

Public Utilities Code Section 854(c) lists eight criteria the Commission must consider before it authorizes the merger, acquisition or control of large electric, gas or telephone utilities:

Before authorizing the merger, acquisition, or control of any electric, gas, or telephone utility organized and doing business in this state, where any of the entities that are parties to the proposed transaction has gross annual California revenues exceeding five hundred million dollars (\$500,000,000), the commission shall consider each of the criteria listed in paragraphs (1) to (8), inclusive, and find, on balance, that the merger, acquisition, or control proposal is in the public interest. *[See headings below for paragraphs (1) through (8)].*

In D.00-05-047, Commission President Loretta Lynch's dissenting opinion made the following observation in the first major water utility merger proceeding under Section 2720:

It is not necessary in this case to address the extent to which the public interest considerations listed in Sections 854(b) and 854(c) may also weigh in the balance. These sections, which require the commission to make certain explicit findings, do not apply by their terms to water utilities. However, the itemization of issues may inform the commission's deliberations on how to strike the public interest balance, and

parties seeking to justify a transfer which involves a rate increase may present how the transfer touches on the itemized issues.

President Lynch and Commissioner Wood made this same observation in their joint concurring opinion in D.00-05-027.

Among other things, Section 854(b) calls for ratepayers to receive not less than 50% of the short-term and long-term forecasted economic benefits of the proposed acquisition. We have already evaluated that aspect of the parties' showings in the Quantifiable Synergies section above.

Before evidentiary hearings began, the assigned ALJ issued a ruling requiring Applicants, and inviting others, to prepare an exhibit which addressed each Section 854(c) criterion explicitly and demonstrated how the acquisition proposal is in the public interest with respect to that criterion. In fact, the Application and supporting exhibits already contained considerable information relating to some of those criteria.

Our critical evaluation of the proposed transaction and CalAm's alternative sharing proposal is set forth in the Ratepayer Benefits and Ratepayer Risks sections above. We take the opportunity here to summarize briefly Applicants' and the intervenors' views of how the proposed acquisition relates to each Section 854(c) criterion. Rather than critique each claim, we will simply state that what the parties have presented under the Section 854(c) summary to follow does not lead us to believe the acquisition under CalAm's alternative sharing proposal is not in the public interest, and reserve further judgment for the Conclusions section to follow.

§854(c)(1): Maintain or improve the financial condition of the resulting public utility doing business in the state

CalAm maintains that consolidation will create significant economies of scale and operating efficiencies obtainable in no other fashion. The combined company will be geographically more diverse and therefore more resistant to disasters, weather phenomena and economic changes. The combined company will have access to greater financial resources, and through American's financing subsidiary, on better terms than in the past. This is all the more true now that Citizens has been downgraded by the debt rating agencies.

ORA finds CalAm's new capital structure and financial ratios would be acceptable, but cautions that should any one of the other five states involved deny American recovery of its acquisition premium, American's cost of new long-term debt would be adversely affected, in turn driving the combined company's needed rate of return, and thus its revenue requirements, higher.

Table 3 above demonstrates to API's satisfaction that CalAm will not be materially adversely impacted by CalAm's alternative sharing proposal. Moreover, CalAm's fate is in its own hands in that it can protect and enhance its financial prospects by continuing to seek efficiencies in its current and newly-acquired operating territories.

§854(c)(2): Maintain or improve the quality of service to public utility ratepayers in the state

ORA believes both Applicants are presently providing dependable and adequate water service and good quality water. Customers thus do not need this acquisition to receive and maintain good water service.

CalAm responds that, although both CalAm and Citizens currently provide high quality service, it is inaccurate to say there cannot be improvement. This is particularly true considering Citizens' decision to exit the water and

wastewater business. As the challenges of the water industry increase, so does the importance of having a specialized provider with the size, expertise and focus of American. Customers will see service benefits as well through training to keep employees and managers abreast of improved practices and technology changes in the industry.

MSD finds nothing in Applicants' proposal that would guarantee currently inadequate service in the Montara District would be improved, and expresses concern lest the consolidation result in less attention to the needs of individual operating districts. As an example of the latter, MSD points to American's proposed nationwide customer call center. CalAm's supply problems in the Monterey Division are not a good sign for Citizens' Montara customers who have long suffered their own water supply inadequacies. CalAm responds that it has shown many ways in which increased efficiencies and expertise from the consolidation will bring service improvements, and that the Commission has both commended it for its efforts in addressing the Monterey Division's supply problems and largely shifted responsibility for addressing the water supply issues in Monterey to the Monterey Peninsula Water Management District.²⁸

API finds a close link between CalAm's financial prospects from the Section 854(c)(1) discussion above and this criterion. CalAm's favorable future financial and service prospects are well-supported in the record.

²⁸ We are unaware of how CalAm believes the Commission has commended it. D.90--10-036, which CalAm cites, does refer to the District as "the agency created by the Legislature to be primarily concerned with resolution of the long-term water shortage problems besetting the Monterey Peninsula."

§854(c)(3): Maintain or improve the quality of management of the resulting public utility doing business in the state

CalAm acknowledges that, as with service, even companies with high-quality management should strive to improve. CalAm believes that the American and CalAm pool of management expertise will be particularly important to providing and retaining management talent given Citizens' decision to exit the business. The combined CalAm and Citizens will be able to select the best management practices of both, provide superior management training and experience, and keep up with and apply new developments in technology in the industry.

API supports the view that management of the combined CalAm operation will improve through the opportunity to draw on the best management personnel available in the former Citizens operation. Further, CalAm's intercession will arrest the attrition of quality management personnel that would otherwise occur as Citizens exits the water business in other states.

§854(c)(4): Be fair and reasonable to affected public utility employees, including both union and nonunion employees

CalAm realizes the impact that consolidation can have and has tried to mitigate that impact on both non-represented and union employees. It began very early with an information and education program to inform employees of the effects consolidation might have on them. A tight labor market will mitigate the effects of many if not most terminations, and non-union employees who do not receive retention offers will receive severance packages. Effects on union employees must be handled through collective bargaining; existing union agreements of each company will remain unaffected by the acquisition. Current Citizens employees who transition to CalAm will enjoy improved training and advancement opportunities, and American's nationwide operations will greatly

expand employees' opportunities to move to other company operations as their personal and professional needs dictate.

The various union parties who were active in the CalAm/SJW merger side of the proceeding did not participate further after the motions to withdraw A.00-05-016. API takes this as a favorable indication with respect to the proposed acquisition's effect on employees.

ORA finds no evidence to suggest adverse effects relating to this factor from the acquisition.

§854(c)(5): Be fair and reasonable to the majority of all affected public utility shareholders

CalAm points out that the boards of directors of both companies have approved the transaction, that it is not aware of any opposition expressed by shareholders of either Applicant, and that there has been no evidence of shareholder concern expressed anywhere in the record of this proceeding. The Applicants explained the arms-length nature of their negotiations in arriving at a reasonable purchase price that fell within the range of recent, like transactions. Finally, the transaction meets the long-term strategic goals of both companies as explained earlier: American's need to grow the firm, and Citizens' need to exit the water business.

ORA finds no evidence to suggest adverse effects relating to this factor from the acquisition.

As with the Section 854(c)(1) criterion, API believes the figures it developed for Table 3 above show that CalAm's financial health will not suffer and its shareholders will not be materially adversely impacted.

§854(c)(6): Be beneficial on an overall basis to state and local economies, and to the communities in the area served by the resulting public utility

Reliable water service providers are essential for state and local economies to prosper. CalAm believes the benefits on which it has elaborated will result in a larger entity that is more financially, technologically and operationally able to provide reliable service over the long term than could each applicant standing alone. It would not be beneficial to require Citizens, a company which has expressed its desire to exit the water business, to continue to provide a vital public service. And finally, a larger CalAm will be more capable of assisting and/or absorbing small, troubled water utilities in the future as a result of its increased size and geographic diversification.

ORA cites here without further comment a letter it included in the record from the Sonoma County Counsel's office to the assigned Commissioner requesting staff advice to assist a citizens group and the Sonoma County Water Agency in their efforts to evaluate the steps needed to form a public entity to take over Citizens' Larkfield District water system. Neither ORA nor any other party developed the record further on this topic.

MSD expresses its continuing concern with the lack of guarantees that CalAm is willing or able to address Citizens' longstanding water supply problems or mitigate the relatively high current rates in Montara District. Absent commitments by CalAm to cooperate with MSD's own water supply development efforts, and Commission adoption of the acquisition approval conditions MSD advocates, MSD sees little prospect for Montara District's problems to be solved at reasonable cost in the future.

API analyzed the acquisition in a way that demonstrates that there are net societal benefits as well as benefits to ratepayers. That, taken with API's

favorable view of the other 854(c) criteria outcomes, assures it that this criterion will be satisfied as well.

§854(c)(7): Preserve the jurisdiction of the commission and the capacity of the commission to effectively regulate and audit public utility operations in the state

Both Citizens and CalAm are currently Commission-regulated water utilities, and CalAm would remain so on behalf of the combined future service territories of the two companies. CalAm believes the Commission's and staff's regulatory workload would decrease because there would be one less company after consolidation, and because CalAm has a reputation for cooperating well with the Commission to solve difficult problems.

ORA finds no evidence to suggest adverse effects relating to this factor from the acquisition.

API echoes CalAm's belief here: CalAm will remain regulated, and the Commission's and staff's regulatory efforts will be more efficient with one company to regulate rather than two.

§854(c)(8): Provide mitigation measures to prevent significant adverse consequences which may result

According to CalAm, there will be no significant adverse consequences other than employee reductions from combining two management staffs into one and the plan to change to a nationwide customer call center. These reductions in force will be mitigated through offers of alternative employment, relocation packages, and severance packages.

ORA finds no evidence other than that presented by the unions to suggest adverse effects relating to this factor from the acquisition.

API points to CalAm's alternative sharing proposal as the strongest mitigation measure: It mitigates potential inter-temporal ratemaking inequities and the near-term rate spikes Section 2720 ratesetting would otherwise

introduce, and still produces an equitable sharing of the benefits this transaction would generate.

Montara Sanitary District's Recommendations

MSD does not oppose the acquisition and transfer *per se*, but would have the Commission put conditions on its approval. MSD's suggested conditions shifted somewhat between the evidentiary hearing and its brief. In the aggregate, those conditions are:

- (1) "CalAm should agree to purchase water supplies from MSD, as developed through groundwater supplies and negotiated water transfers."
- (2) "CalAm should agree to participate and be a member of the Groundwater Management District that MSD proposes to create."
- (3) "Citizens and CalAm should agree to an arrangement in which a connection fee, such as a fire-flow connection fee, would be levied on new connections [...by MSD]."
- (4) "Cost savings resulting from the sale and transfer should go to improving water service in the Montara Division."
- (5) "CalAm should retain the Citizens office in Montara and staff it with adequate personnel and necessary administrative support to provide safe and reliable water service."
- (6) "Citizens should be required to allocate a reasonable portion of the acquisition premium CalAm has agreed to pay to such capital expenditures for the Montara District system improvements the Commission may determine necessary in A.00-10-049."
- (7) "CalAm should be required to explore the feasibility and rate impacts of consolidating districts and regionalization of rates across CalAm and Citizens districts in A.00-10-049."

It was noted early in the evidentiary hearings that Citizens, MSD and CalAm were all parties in a separate proceeding, A.00-10-049, in which

Citizens seeks approval of its Water System Master Plan Update for Montara District, and that at least some part of what MSD sought in this proceeding was also at issue in that proceeding. Indeed, in December 2000, MSD filed a motion to consolidate the two proceedings, which the assigned ALJs jointly denied. MSD was not foreclosed from participating in this proceeding, however, so long as its presentation appeared arguably relevant to the Applicants' request for authority to acquire and transfer Citizens' assets.

MSD's first three recommendations above are issues, or closely related to issues, in A.00-10-049. CalAm has stated that it is committed to standing in Citizens' shoes with respect to any historic or future obligations the Commission may impose with respect to the former Citizens service territories and customers. CalAm is a party in A.00-10-049 and will assume any obligations the Commission might place on Citizens as a result of the decision in that proceeding.

A.00-10-049 is the proper forum for evaluating Citizens' Water System Master Plan Update and future service improvements associated with Montara District's historic water supply problems. MSD's first three conditions will not be imposed in this Application.

MSD's fourth and sixth recommendations above would have CalAm forego some of its earnings, and Citizens relinquish part of its gain on this sale, for the benefit of Montara District ratepayers in coming years. The seventh recommendation is related in that it suggests future ratemaking treatment for Montara ratepayers' benefit. MSD argues on brief, "If the acquisition and transfer is approved as proposed by Citizens and CalAm, rates in the Montara District are virtually certain to increase further, and most likely substantially so."

MSD did cite evidence of very high current rates in Montara District, and Citizens concedes that rates in Montara are "comparatively high." But this is

not a proceeding to set rates; the specific level of rates and quality of service in Montara are not at issue except to the extent that the acquisition itself could have a positive or negative impact on them. Nothing in MSD's presentation or any other part of the record here supports a contention that this acquisition, *per se*, will drive rates higher or service quality lower than they would otherwise be, and in fact the opposite may well be the case. MSD itself seems to endorse that conclusion on brief: "Citizens implementation of the Master Plan Update would result in a projected rate impact that is somewhat greater than CalAm's implementation of the Master Plan Update, under the acquisition proposal." The record supports that conclusion in that it shows CalAm's costs to provide service to former Citizens ratepayers in all districts including Montara will be lower than Citizens' costs. This is the source of CalAm's projected synergies savings. Ratepayers, including Montara District ratepayers, will share those significant synergies savings if the acquisition is consummated. In fact, the synergies savings will benefit ratepayers in much the same way as would MSD's proposed contribution of a portion of Citizens' purchase premium and CalAm's cost reductions. If the acquisition were disapproved, or if it were approved with conditions so onerous that Applicants decided not to proceed, there would be no synergies savings and ratepayers would be the worse off for it by having lost both the quantifiable benefits and the non-monetary or non-quantifiable benefits the acquisition would provide.

MSD further argues, "If the sale and acquisition is approved, as proposed by Citizens and CalAm, without the conditions recommended by MSD, Citizens will no longer have any responsibility for service to the Montara District and absolutely no responsibility for implementing whatever improvements the Commission may find required after hearings in A.00-10-049." We are aware of no legal principle or precedent that would require us to

condition approval of the acquisition on Citizens' being willing to leave behind a portion of its gain on sale for the benefit of Montara ratepayers.²⁹ We are particularly disinclined to do so here, where Applicants have shown CalAm to be willing and equally or more qualified to assume any and all of Citizens' public utility obligations, and the transfer to CalAm would itself generate at least part of the ratepayer benefit MSD seeks.

For the foregoing reasons, we will not impose MSD's fourth and sixth conditions.

MSD's fifth recommendation was, "CalAm should retain the Citizens office in Montara and staff it with adequate personnel and necessary administrative support to provide safe and reliable water service." We have already stated our expectations of CalAm with respect to customer service locations in the Service Degradation section above. In addition, Health and Safety Code Section 116555(a)(3) requires water suppliers to provide a reliable and adequate supply of pure, wholesome, healthful, and potable water. Our General Order 103 similarly imposes service and water quality standards on the providers subject to our jurisdiction. No further order with respect to MSD's fifth condition is required in this proceeding.

MSD's request that CalAm be required to explore the feasibility and rate impacts of consolidating districts and regionalization of rates across CalAm and Citizens districts is outside the scope of this proceeding. To the extent it seeks relief in the order that results from A.00-10-049, its request should be made

²⁹ Citizens, in fact, cites three decisions stating the Commission's policy for shareholders to keep all proceeds when a transfer results in the total liquidation of a utility: Redding II, 32 CPUC 2d 233 (1989); Ambler Park Water Utility, D.98-09-038; and California Water Service, 47 CPUC 2d 580, 598 (1993).

in that proceeding. We also note that issues such as requests for rate changes and regionalization are more typically addressed in water companies' periodic general rate case proceedings. Thus, MSD's seventh condition will not be imposed here.

Conclusions

While it is not possible to forecast with certainty the benefits the acquisition will generate for CalAm and ratepayers, CalAm's latest synergies study and the results set forth in Tables 1, 2 and 3 are sufficiently reliable and conclusive for our purposes in this proceeding.

Table 1 convinces us that CalAm's alternative sharing proposal is more favorable to ratepayers in terms of reducing revenue requirement than the "\$2720 Return On Only" and "\$2720 Return Of and On" alternatives, and far better than the No-Acquisition alternative. Table 2 shows that CalAm's alternative sharing proposal delivers to ratepayers roughly half of the synergies savings generated by the acquisition and is far better for ratepayers than the No-Acquisition alternative. Similarly, API's Table 3 shows that ratepayers' share of the net benefits compares favorably with that of Applicants.³⁰

API's presentation of the likely rate effects shows that, after initially higher rates during the first two to three years, authorizing the acquisition under any of the three ratemaking treatments would produce significantly lower rates than the No-Acquisition alternative for the indefinite future. Of the three Section 2720-compliant acquisition ratemaking treatments, CalAm's alternative

³⁰ As noted earlier, these conclusions remain valid even though we disregard the stayout benefits.

sharing proposal is best because it is the only one which does not increase rates at any time, yet it provides comparable rate decreases for the indefinite future.

We agree that in the aggregate the non-quantifiable and non-monetary advantages Applicants claim are valid and significant benefits, although they would not have been sufficient in themselves to overcome Section 2720's ratesetting disadvantages had CalAm not offered the alternative sharing proposal.

No party contends that CalAm is not fully qualified to assume the public utility responsibilities now borne by Citizens, or that CalAm would be any less qualified than Citizens in that regard.

CalAm's acquisition of Citizens' water utility assets is in the public interest. We will approve the acquisition under the conditions outlined above pertaining to CalAm's alternative sharing proposal.

Other Matters

Environmental Review

Applicants in A.00-05-015 acknowledge that the transfer of control proposed in the Application may constitute a project under the California Environmental Quality Act (CEQA), Public Resources Code Section 21000 *et seq.* However, since it can be seen with certainty that no significant effect on the environment could result from our granting the authorization, the proposed transaction qualifies for an exemption from CEQA pursuant to Section 15061(b)(3) of the CEQA guidelines. Therefore, no further environmental review by the Commission is required.

Health and Safety Code Compliance

Health and Safety Code Section 116525(a) requires the prospective operator of a public water system to submit an application to the California Department of Health Services and receive a permit before operating the system:

No person shall operate a public water system unless he or she first submits an application to the department and receives a permit as provided in this chapter. *A change in ownership of a public water system shall require the submission of a new application.* [Emphasis added.]

The ensuing Health and Safety Code sections establish the application and review processes.

CalAm acknowledges in A.00-05-015 that it must comply with Health and Safety Code Section 116525 *et seq.* when it acquires Citizens' water system assets. It has indicated it will do so.

Comments on the Proposed Decision

The principal hearing officer's proposed decision in this proceeding was filed with the Commission and served on the parties in accordance with Section 311(d) and the Commission's Rules of Practice and Procedure, Rule 77.1.

CalAm, Citizens, ORA and MSD filed comments; CalAm, Citizens, and MSD filed replies. Applicants CalAm and Citizens support the proposed decision and urge the Commission to adopt it in time for them to complete the transaction before their agreement expires on September 30, 2001. Intervenors ORA and MSD primarily reargued positions taken earlier on the record. API served notice that it found the proposed decision to be in the public interest and was waiving its opportunity to comment.

We have made no substantive changes in response to the comments and replies. We have, however, made minor changes in response to CalAm's and Citizens' comments: to update the decision to reflect developments since the

proposed decision was filed; to correct a minor error in the description of American's current customer base in other states; and to clarify ORA's position on stay-out benefits.

Findings of Fact

1. American and Citizens' parent company have agreed to a pay \$835 million for Citizens' water and wastewater assets in six states. The six-state purchase was the result of arms-length negotiations and resulted in a purchase price that represents fair market value for those assets.

2. American and Citizens' parent company have allocated 19.32% of the six-state purchase price to California assets, based on the proportion of Citizens' gross water and wastewater plant in California. This method of allocating the purchase price to California is reasonable, and the resulting \$161.32 million price allocated to California assets represents fair market value for those assets.

3. The net book value of the California assets being purchased is \$93.957 million. The excess of purchase price over net book value of the California assets is \$67.363 million. Of that excess, an estimated \$2.810 million represents the excess of fair market value over net book value for non-regulated assets, leaving an estimated \$64.553 million as the acquisition premium for the California regulated assets. The acquisition premium includes approximately \$1.2 million in transaction costs.

4. The \$2.810 million estimated excess of market value over net book value for California non-regulated assets, and thus the estimated acquisition premium, will be adjusted if market value of the non-regulated assets is higher at the time of closing.

5. Consolidating Citizens' water assets into CalAm will permit very significantly increased economies of scale related to Citizens' current water

service areas, and more modest but still significantly increased economies of scale in CalAm's current operating divisions.

6. CalAm presented and revised a synergies study that quantifies the savings associated with the increased economies of scale it expects to achieve by consolidating Citizens' service areas into its own operations. CalAm's synergies study is sufficiently reliable for our purposes in evaluating the proposed acquisition.

7. CalAm has proposed for the future two ratesetting methods (the Application sharing proposal, and the alternative sharing proposal) that involve sharing with ratepayers the quantifiable synergies savings it is able to achieve by consolidating Citizens' service areas into its own operations. Each of those methods would involve ratemaking treatment of an acquisition adjustment equal to the acquisition premium, in a way that meets the requirement of Section 2720.

8. CalAm's alternative sharing proposal is more favorable for ratepayers than its Application sharing proposal.

9. CalAm's alternative sharing proposal includes the following major elements:

- a. CalAm would book the acquisition premium for California regulated assets as an acquisition adjustment to be amortized mortgage-style over 40 years beginning in 2002. This mortgage-style amortization represents the return of and on the acquisition adjustment.
- b. CalAm would recover in rates all proven synergies savings in 2002, 2003, and 2004.
- c. Beginning in 2005, CalAm would recover in rates the proven synergies savings up to the amortization amount, plus 10% of any proven synergies savings in excess of the amortization amount, the other 90% to remain with ratepayers.
- d. If proven synergies savings were insufficient to recover the full amortization amount in any year beginning in 2002, CalAm would

suffer the shortfall and no part of the shortfall would be carried forward to a subsequent year.

- e. Ratepayers would receive all synergies savings after the acquisition adjustment has been amortized; *i.e.*, beginning in 2042 rates would return to being based on cost of service.
- f. There would be no general rate case stayout period going forward.
- g. The GRC filing schedule would be:
 - (1) Citizens Division GRC filed in January, 2002 for rates effective for test years 2003 and 2004.
 - (2) Citizens Division GRC filed in January, 2004 for rates effective 2005.
 - (3) Monterey Division and General Office GRCs filed in January, 2002 for test years 2003 and 2004 and attrition year 2005.
 - (4) Los Angeles and Village Division GRCs filed in January, 2003 for rates effective 2004.
 - (5) Coronado Division GRC filed in January, 2004 for rates effective in 2005.
- h. CalAm would prove its claimed synergies savings in the 2002 GRC filing, and the Commission would review them again in the 2004 GRC filing to ensure CalAm had achieved and maintained them. Thereafter, they would be carried forward using agreed-upon escalation methods and factors. CalAm would carry the burden of proving that any new or increased GRC expenses (excluding those due to inflation and customer growth) in future years were not erosions of earlier-estimated synergies.
- i. Liability for historic advances would remain with Citizens and CalAm would not record historic advances and contributions on its books. To ease the transitional effect on rates, CalAm would initially treat those advances and contributions as a rate base deduction for ratemaking purposes in the Citizens Division, to be ratably restored over 20 years.

10. The proposed stipulation entered into by Applicants and ORA is reasonable for the purpose of demonstrating the level of synergies savings CalAm is likely to achieve through the acquisition.

11. The stipulation entered into by Applicants and ORA, while not permitted to predetermine the outcome of substantive issues which may come before the Commission in future proceedings, may prove a valuable reference in future proceedings to establish the level of synergies achieved.

12. Reductions in expenses generated by reducing services are not in themselves synergies and should not be treated as such in any future synergies-determination filings.

13. Only cost savings that clearly could not have been achieved absent consolidation are synergies savings within the meaning of that concept in this proceeding. Only such synergies savings are to be counted in any future synergies-determination GRC filings.

14. The figures in Tables 1, 2 and 3 and API's estimates of the likely rate effects under various ratesetting methods in the body of this decision are sufficiently reliable and conclusive for our purposes in evaluating the proposed acquisition and CalAm's alternative sharing proposal.

15. Of the three Section 2720-compliant ratesetting methods considered, CalAm's alternative sharing proposal is the only one which does not increase rates in the very near term, yet it provides rate decreases comparable with those of the other methods for the indefinite future.

16. When the time value of money is recognized, CalAm's alternative sharing proposal is more favorable for ratepayers than either of the other two Section 2720-compliant ratesetting methods considered (as shown in Table 1).

17. The stayout benefits CalAm imputes to ratepayers as a result of this transaction should not be given weight as quantifiable benefits in evaluating the

acquisition. Ratepayers may be receiving some value, albeit speculative, not reasonably quantifiable, and not dependent on whether the acquisition is or is not completed, associated with Applicants' having filed the Application.

18. The acquisition is likely to generate in excess of \$100 million in net present value benefits to all participants in the aggregate.

19. Under CalAm's alternative sharing proposal, ratepayers are likely to receive roughly one-half of the net present value of the quantifiable benefits generated by the acquisition (as shown in Tables 2 and 3, after disregarding stayout benefits).

20. The non-quantifiable and non-monetary advantages Applicants claim ratepayers would realize from the acquisition are valid and significant benefits.

21. Citizens, MSD and CalAm are all parties in a separate proceeding, A.00-10-049, in which Citizens seeks approval of its Water System Master Plan Update for Montara District.

22. Contrary to MSD's assertions, under the terms of CalAm's alternative sharing proposal this acquisition would not drive rates higher or service quality lower than they would otherwise be, and in fact the opposite is likely to be the case.

23. Good cause has not been shown to require a portion of the cost savings resulting from the sale and transfer go specifically to improving water service in the Montara District as MSD requests.

24. CalAm is fully qualified to assume the public utility responsibilities now borne by Citizens in providing water service to the current Citizens serving areas.

25. CalAm's alternative sharing proposal provides to ratepayers an equitable share of the anticipated benefits of the acquisition, given the costs and risks imposed on them.

Conclusions of Law

1. A.00-10-049 is a more proper forum than this proceeding for evaluating Citizens' Water System Master Plan Update and ordering any needed future service improvements associated with Montara District's historic water supply problems.
2. MSD's request that CalAm be required to explore the feasibility and rate impacts of consolidating districts and regionalization of rates across CalAm and Citizens districts in A.00-10-049 is misplaced and outside the scope of this proceeding.
3. As a party in A.00-10-049, and as a successor to Citizens' public utility obligations should the transfer be completed, CalAm will assume any obligations the Commission might place on Citizens as a result of the decision in that proceeding.
4. MSD's request that Citizens be required to allocate a portion of its gain on sale in this transaction to pay for future capital expenditures in the Montara system should be denied.
5. It is not necessary to make an order in this proceeding directing CalAm to do what the law and our rules already require, *i.e.*, to provide safe and reliable water service in Montara District.
6. The stipulation entered into by Applicants and ORA should be accepted for the purpose of demonstrating the level of synergies savings CalAm is likely to achieve through the acquisition.
7. The Commission should not in this proceeding foreclose parties in future proceedings from proposing and supporting methods and figures for quantifying actual synergies savings achieved.

8. In order for an acquisition subject to Section 2720 to be in the public interest under Sections 851 and 854(a), it must offer to ratepayers an equitable share of the benefits the transaction will generate.

9. Sections 854(b) and 854(c) do not by their terms apply to water utilities. The Commission may, but need not, consider the extent to which the factors set forth in those sections bear on the public interest in this proceeding.

10. CalAm's alternative sharing proposal complies with Section 2720.

11. CalAm's alternative sharing proposal as described in the Findings of Fact of this order should be adopted.

12. CalAm's acquisition of Citizens' water utility assets is in the public interest.

13. The acquisition should be approved, subject to the conditions set forth in this order.

14. The sale, acquisition and transfer of control proposed in A.00-05-015 is a project that qualifies for an exemption from CEQA pursuant to Section 15061(b)(3) of the CEQA guidelines.

15. Pursuant to California Health and Safety Code Section 116525(a), CalAm must submit an application to the California Department of Health Services and receive a permit before operating the public water systems it acquires from Citizens.

16. California-American Water Company's and SJW Acquisition Corp.'s motion to dismiss A.00-05-016, and SJW Corp.'s and San Jose Water Company's motion to dismiss A.00-05-016, were unopposed and should be granted.

17. This order should be made effective immediately to allow the parties to complete the transaction before the September 30, 2001 expiration of the Asset Purchase Agreement.

O R D E R

IT IS ORDERED that:

1. Citizens Utilities Company of California (Citizens) is authorized to sell and transfer, and California-American Water Company (CalAm) is authorized to acquire, all of Citizens' California water utility assets upon the terms and conditions set forth in the Asset Purchase Agreement in Application

(A.) 00-05-015. This authority is granted subject to the conditions set forth in the Ordering Paragraphs that follow.

2. As a condition of the authority granted in this order, CalAm shall assume Citizens' existing Safe Drinking Water Bond Act Loan long term secured indebtedness to the California Department of Water Resources.

3. As a condition of the authority granted in this order, the Commission adopts for future ratesetting purposes CalAm's alternative sharing proposal, the major elements of which are summarized in the Findings of Fact of this order.

4. The acquisition adjustment to be used for future ratesetting for CalAm is estimated to be \$64.553 million, derived as described in the Findings of Fact in this order. That amount shall be adjusted if, and to the extent that, at the time of closing the fair market value of the non-regulated assets exceeds their net book value by more than the \$2.810 million estimate used to derive the estimated acquisition adjustment.

5. Upon completion of the transfer, CalAm shall assume all of Citizens' public utility obligations, including responsibility for compliance with all outstanding Commission orders in effect as of the date of transfer, relating to water service in the former Citizens serving areas, and Citizens is relieved of those water public utility obligations.

6. Montara Sanitary District's requests for relief are denied.

A.00-05-015, A.00-05-016 ALJ/JCM/eap *

7. CalAm's and SJW Acquisition Corp.'s motion to dismiss A.00-05-016, and SJW Corp.'s and San Jose Water Company's motion to dismiss A.00-05-016, are granted. A.00-05-016 is dismissed.

8. A.00-05-015 and A.00-05-016 are closed.

This order is effective today.

Dated September 20, 2001, at San Francisco, California.

LORETTA M. LYNCH
President
HENRY M. DUQUE
RICHARD A. BILAS
CARL W. WOOD
GEOFFREY F. BROWN
Commissioners

APPENDIX A

(List of Appearances)

E. Garth Black, Attorney at Law, for Citizens Utilities Company of California, applicant.

Lenard G. Weiss, Attorney at Law, for California-American Water Company, SJW Acquisition Corp., SJW Corp., and San Jose Water Company, applicants.

John S. Barker, Dave Stephenson, and Paul G. Foran, for California-American Water Company, applicant.

Palle Jensen, for San Jose Water Company, applicant.

Peter G. Fairchild, Attorney at Law, and Raymond A. Charvez, for Office of Ratepayer Advocates, Water Utilities Branch, interested party.

Ron Knecht, for Advocates for the Public Interest, interested party.

Bernardo R. Garcia, for Utility Workers Union of America, AFL-CIO, interested party.

Drucilla M. Redwine, David Guardino, and Chris Method, for Utility Workers Union of America – Local 259, interested party.

Tina Haynes, for Utility Workers Union of America – Local 511, interested party.

Edward W. O'Neill, Attorney at Law, Jane Whang, George Irving, and Reed V. Schmidt, for Montara Sanitary District, interested party.

Gerard Orme, for Operating Engineers Local Union No.3 of the International Union of Operating Engineers, AFL-CIO, interested party.

Patrick J. Power, Attorney at Law, Anthony C. Bennetti, Attorney at Law, and Keith Whitman, for Santa Clara Valley Water District, interested party.

(END OF APPENDIX A)